85-519

No. ———

Supreme Court, U.S.
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IN THE

Supreme Court of the United States

October Term, 1985

DR. WILLIAM C. RANDALL, DR. ROGER E. AUSTIN, DR. TOM W. ANDERSON and DR. MYREL A. NEUMANN,

Petitioners,

v.

B. J. LOFTSGAARDEN; ALOTEL INCORPORATED, a Minnesota corporation; PROPERTY DEVELOPMENT AND RESEARCH COMPANY, a Minnesota corporation; and 2361 BUILDING CORPORATION, a Minnesota corporation,

Respondents.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

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QUESTIONS PRESENTED

1. Whether favorable tax consequences to defrauded investors in a limited partnership, together with imputed interest thereon, constitute "income received" which section 12(2) of the Securities Act of 1933 requires be deducted from the consideration paid when the investors' purchase of the securities is rescinded.

2. Whether favorable tax consequences to defrauded investors in a limited partnership, together with imputed interest thereon, are to offset rescissionary damages awarded pursuant to section 10(b) of the Securities Exchange Act of 1934 and Securities and Exchange Commission Rule 10b-5 to insure that the investors do not recover more than "actual damages."*

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*A similar issue is raised both by a petition for certiorari in *Salcer v. Envicon Equities Corp.*, No. 84-1447 (U.S., filed Mar. 13, 1985) and by a petition for certiorari in *Freschi v. Grand Coal Venture*, No. 85-377 (U.S., filed Sept. 6, 1985).

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B. J. LOFTSGAARDEN; ALOTEL INCORPORATED, a Minnesota corporation; PROPERTY DEVELOPMENT AND RESEARCH COMPANY, a Minnesota corporation; and 2361 BUILDING CORPORATION, a Minnesota corporation,

Respondents.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

Petitioners respectfully pray that a writ of certiorari issue to review the *en banc* judgment and opinion of the United States Court of Appeals for the Eighth Circuit entered in this proceeding on July 16, 1985.

OPINIONS BELOW

The *en banc* opinion of the Eighth Circuit and the accompanying panel opinion (hereinafter *"Austin II"*) are reported at 768 F.2d 949 and are set forth in Appendix A. The unreported Amended Judgment and Order of the district court on an earlier remand are set forth in Appendices

B and C. The earlier opinion of a panel of the Eighth Circuit (hereinafter "*Austin I*") is reported at 675 F.2d 168 and is set forth in Appendix D. The unreported Findings of Fact, Conclusions of Law and Order for Judgment and Memorandum Order of the district court are set forth in Appendices E and F.

JURISDICTIONAL STATEMENT

The judgment of the Court of Appeals for the Eighth Circuit was entered on July 16, 1985. This petition for certiorari is being filed within ninety days of that date. This Court's jurisdiction is invoked pursuant to 28 U.S.C. § 1254(1).

STATUTES AND REGULATION

The case involves section 12(2) of the Securities Act of 1933, 15 U.S.C. §77*l*(2); section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j(b); section 28(a) of the Securities Exchange Act of 1934, 15 U.S.C. §78bb(a); and Rule 10b-5 of the Securities Exchange Commission, 17 C.F.R. §240.10b-5. Because of the length of the statutes and regulation, their text is set forth in Appendix G.

STATEMENT OF THE CASE

Petitioners are four investors who purchased one or more units[1] in Alotel Associates, a limited partnership formed to operate a Ramada Inn in Rochester, Minnesota. Respondents are the individual and corporate general partners of Alotel Associates and their affiliates.

Respondents distributed an Offering Memorandum to potential investors, including Petitioners. The Offering

[1]The price of each unit was $35,000.00.

Memorandum purported to describe the limited partnership, the Ramada Inn project, the terms available for financing the partnership's activities and the timetable for constructing the Ramada Inn. The Offering Memorandum contained a *pro forma* projection of cash flow, of resale price and profit at the time of sale and of the tax consequences of a limited partner's investment.

The Offering Memorandum misrepresented the rate and amount of interest to be paid for construction financing, the length of a ground lease, the completion date and the terms of financing available for furnishings and equipment. The Offering Memorandum described a non-existent commitment for long-term financing. The Offering Memorandum omitted information about the control B. J. Loftsgaarden ("Loftsgaarden") exercised over Alotel Incorporated, Property Development and Research Company ("PDRC") and 2361 Building Corporation, about PDRC's anticipated profits on a sale of land, about a commitment fee to be paid to PDRC and about Loftsgaarden's ownership of arc-TECH, inc., a firm which was to design the building and to supervise construction.

The limited partners' investments and the available loans proved insufficient to construct and furnish the Ramada Inn. Alotel Associates had no initial operating capital. Alotel Associates was forced to obtain additional investors. The additional investments proved insufficient, and the business continued to flounder. The investors made several loans to Alotel Associates.[2] Alotel Associates ultimately defaulted on its loans and its rental payments, and its creditors foreclosed.

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[2]The total loans "assessed" against each unit was $8,500.00.

Petitioners brought suit under section 12(2) of the Securities Act of 1933 [hereinafter "section 12(2)"], section 10(b) of the Securities Exchange Act of 1934 [hereinafter "section 10(b)"], under Securities and Exchange Commission Rule 10b-5 (hereinafter "Rule 10b-5"), under the antifraud provisions of the Minnesota Uniform Securities Act and under the common law of Minnesota. Petitioners alleged fraud and omission of material information and sought rescission or damages.

Respondents denied liability. They also argued that reductions in Petitioners' federal and state income tax liabilities which flowed from Petitioners' investments in Alotel Associates constituted "income received," which section 12(2) mandates be deducted from any recovery which the district court awarded to Petitioners if it granted rescission. Respondent also argued that the tax consequences reduced the "actual damages" to which Petitioners might be entitled under section 10(b) and Rule 10b-5.

The district court sustained objections to evidence which Respondents sought to introduce concerning the tax consequences of Petitioners' investments in Alotel Associates. The district court determined that the "out-of-pocket [and] rescissionary measures [of damages] would yield the same results." Appendix at F-7. Based upon the jury's verdict and its own findings, the district court awarded Petitioners judgment in amounts equal to the amounts of their investments plus interest[3] on the amounts of their investments.[4]

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[3]Interest was awarded pursuant to the statutory mandates in section 12(2) and in Minn. Stat. §80A.23, subd. 2. Another basis would have been the provision of Minnesota law which allows an award of prejudgment interest if a judgment is for a "sum certain" or does not depend on any contingency and can be ascertained by reference to a generally recognized standard. *See, e.g., Oliver-Elec. Mfg. Co. v. I.O. Teigen Constr. Co.*, 183 F. Supp. 768, 769 (D. Minn. 1960).

[4]The district court denied Petitioners a return of their "loans" to Alotel Associates. *Austin II* at 951 n.2.

Respondents appealed. The Eighth Circuit affirmed the jury's and the district court's findings of liability, but the Eighth Circuit vacated and remanded to the district court for a new trial on the issue of damages. The Eighth Circuit held that

> in a private securities fraud action involving an investment structured and marketed as a tax shelter, where a rescissory measure of damages is applied, evidence of any benefit derived by the plaintiff/investor via tax savings must be permitted.

Austin I at 183-84. The Eighth Circuit also held that "the damage award must be reduced by any value shown to have been received by plaintiffs." *Austin I* at 181.

On remand, the district court stated:

> [T]he starting point for assessing damages will be the amount each plaintiff paid Loftsgaarden for his investment (in other words, the plaintiff's consideration). To this, the court will add 8 percent interest from the date the consideration was paid to the date of this order. Finally, the amount of each plaintiff's tax benefits will be subtracted from the sum of his consideration and interest.

Appendix at C-5. The district court then made the following calculations and awards:

Plaintiff Anderson	
Consideration paid June 2, 1983:	$35,000.00
Plus interest at 8% to February 22, 1984:	$64,787.00
Minus tax benefits:	$29,615.00
Total Damages:	$35,172.00

Plaintiff Austin	
Consideration paid June 6, 1983:	$35,000.00
Plus interest at 8% to February 22, 1984:	$64,610.00
Minus tax benefits:	$33,333.00
Total Damages:	$31,277.00
Plaintiff Ne[u]mann	
Consideration paid August 21, 1973:	$35,000.00
Plus consideration paid October 19, 1973:	$17,500.00
Plus interest at 8% to February 22, 1984:	$96,385.00
Minus tax benefits:	$57,014.00
Total Damages:	$39,371.00
Plaintiff Randall	
Consideration paid November 13, 1973:	$35,000.00
Plus interest at 8% to February 22, 1984:	$63,770.00
Plus consideration paid 1975:	$ 2,512.00
Plus interest at 8% to February 22, 1984:	$ 4,203.00
Subtotal:	$67,973.00
Minus tax benefits:	$36,404.00
Total Damages:	$31,569.00

Appendix at B-1-2.

Respondents again appealed. The Eighth Circuit *sua sponte* granted *en banc* consideration as to whether *Austin I* should be reconsidered and as to whether damages had been calculated properly if *Austin I* had been decided properly. *Austin II* at 951. The Eighth Circuit holds that *Austin I* had been correctly decided and that *Austin I* requires a further reduction in the recovery when ever a court order rescission under section 12(2); it adopts a

formula for computing damages: two times the sum of the amount paid for the security with interest, less the amount of tax benefits received with imputed interest. The Eighth Circuit therefore reduced the awards to the following: Austin ($7,666), Anderson ($18,790), Neumann ($1,984), Randall ($506). *Austin II* at 961.

Petitioners now pray that a writ of certiorari issue to review the Eighth Circuit's decision.

REASONS FOR ISSUING THE WRIT

I.

THE EIGHTH CIRCUIT'S DECISION CONFLICTS WITH THE DECISIONS OF OTHER COURTS OF APPEAL

A.

The Eighth Circuit's Decision Conflicts With A Decision Of The Ninth Circuit As To The Proper Interpretation Of Section 12(2).

Section 12(2) provides that a defrauded purchaser of a security who tenders the security to the seller is entitled

> to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon . . . .

The Eighth Circuit recognizes that "tax benefits received are [not] income in a strict accounting sense."[5] *Austin II* at 955. Nevertheless, the Eighth Circuit holds that

> section 12(2)'s requirement that "income received" be

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[5]John M. Carlson, an accounting expert called by Respondents, provided the only testimony concerning whether "tax benefits" constituted "income;" he readily conceded that "tax benefits" were not "income."

> deducted [requires] that all economic benefits bargained for and received must be deducted.

Id.

In so holding, the Eighth Circuit concedes that its interpretation might conflict with the one adopted by the Ninth Circuit in *Western Fed. Corp. v. Erickson*, 739 F.2d 1439, 1444 (9th Cir. 1984) and reaffirmed in *Burgess v. Premier Corp.*, 727 F.2d 826, 837-38 (9th Cir. 1984). The Eighth Circuit seeks to justify a distinction by characterizing Petitioners' recovery under section 12(2) as "rescissionary damages," *Austin II* at 953, and by stating that "a different situation might exist in a case involving actual rescission." *Id.* at 955 n.11; *see also id.* at 952 n.4.

The Eighth Circuit's characterization flies in the face of the district court's findings and in the face of *Austin I*'s rejection of an argument that "rescission under [section] 12(2) was not an available remedy." *Austin I* at 179. The characterization also disregards the statutory language which permits recovery of damages under section 12(2) only if a defrauded purchaser "no longer owns the security." 15 U.S.C. § 77*l*(2); *see also Johns Hopkins Univ. v. Hutton*, 297 F. Supp. 1165, 1226 (D. Md. 1968), *rev'd on other grounds*, 422 F.2d 1124 (4th Cir. 1970), *cert. denied*, 416 U.S. 916 (1974).

The Eighth Circuit's best rationale is that its interpretation reflects "economic reality" and that to ignore "tax benefits actually realized . . . would be unrealistic." *Id.* at 955 & n.9. That rationale flies in the face of the cardinal principle underlying rescission: "[r]escission voids the transaction and returns to [each] part[y] the consideration [he] paid." *Burgess v. Premier Corp.*, 727 F2d at 837. The Eighth Circuit gives lip service to the principle by stating that "[t]he goal of rescission under section 12(2) is to return the parties

to the status quo ante," *Austin II* at 954, and purports to return Petitioners to the status quo ante. The Eighth Circuit, however, never purports to return Respondents to the status quo unlawfully obtained profits. By permitting Respondents to retain a profit of at least $100,000, *id.* at 963 (dissenting opinion), the Eighth Circuit's interpretation fails to apply another basic principle of rescission: in shaping a remedy, a court should give the defrauded person, rather than the defrauder, any windfall. *Janigan v. Taylor,* 344 F.2d 781, 186 (1st Cir.), *cert denied,* 382 U.S. 879 (1965); *see also Gerstle v. Gamble-Skogmo, Inc.,* 478 F.2d 1281, 1305 (2d Cir. 1973); *Johns Hopkins Univ. v. Hutton,* 297 F. Supp. at 1226.

The Ninth Circuit takes an opposite view. When a district court ruled:

> While this Court has *considered* the economic benefits to the plaintiffs from their investments with the defendants, as required by *Austin* [*I*], it concludes that the defendants should not be given any credit,

Western Fed. Corp. v. Davis, 553 F. Supp. 818, 820 (D. Ariz. 1982) (emphasis in original), the Ninth Circuit affirmed:

> Appellants argue that the district court erred by refusing to reduce the judgment by the amount of tax benefits appellees realized from their investment in the Project. Our recent decision in *Burgess v. Premier Corp.,* 727 F.2d 826, 837-38 (9th Cir. 1984) refused to deduct tax benefits in a securities case and specifically endorsed the reasoning of the district court in this case. The appellants' argument is without merit.

Western Fed. Corp. v. Erickson, 739 F.2d at 1444; *accord, Johns Hopkins Univ. v. Hutton*, 297 F. Supp. at 1232 (cash payments to be applied to taxes were "not to be classified as . . . 'income' ").

The Ninth Circuit does not permit deduction of tax benefits from a defrauded investor's recovery under section 12(2). The Eighth Circuit limits such a recovery to the purchaser's consideration paid plus interest thereon less the amount by which his state and federal income taxes are reduced as a result of his investment plus interest on the tax reduction. Thus, the conflict is complete.

B.

The Eighth Circuit's Decision Conflicts Both With Decisions Of The Ninth Circuit And With Decisions Of The Second Circuit As To The Measure Of Damages Under Rule 10b-5.

Neither section 10(b) nor Rule 10b-5 creates an express private right of action. *E.g., Herman & MacLean v. Huddleston*, 459 U.S. 375, 379-80 (1983); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 196 (1976); *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 13 n.9 (1971). Nevertheless, courts have recognized such a private right for almost forty years. *Herman & MacLean v. Huddleston*, 459 U.S. at 380 n.10; *Kardon v. National Gypsum Co.*, 69 F. Supp. 512, 513-14 (E.D. Pa. 1946). The "legal" remedy for that right is "actual damages." 15 U.S.C. § 78bb(a).

The Eighth Circuit purports to apply the "actual damages" limitation. In doing so, the Eighth Circuit concludes that, in order to limit a defrauded purchaser's recovery to his "actual damages," a court must reduce damages by "the tax benefits [the purchaser] received." *Austin II* at 955. In so holding, the Eighth Circuit states:

> [A]ll economic benefits bargained for and received must be deducted from plaintiffs' damages because "the strictly compensatory nature of damages awarded in private securities fraud actions requires that such value be taken into account in determining whether and to what extent damages were inflicted upon plaintiffs."

Id., quoting Austin I at 183. The Eighth Circuit goes on:

> [I]n order for the plaintiffs to be truly made whole, and to be returned to the status quo ante, both the tax benefits received *and* the tax consequences of their recovery must be taken into account.

Id. at 960 (emphasis in original).

The Ninth Circuit rejects both the Eighth Circuit's reasoning and its result:

> [The defendants] claim that the tax benefits received by the [plaintiffs] should be deducted from the damage award. In this case, deduction of the tax benefits from damages is inappropriate. The purpose of the damages is to place the [plaintiffs] in as good a position financially as that in which they would have been had they not made the transaction. . . . At first appearance it seems inequitable to award the [plaintiffs] their pretax out of pocket losses . . . . [T]o simply subtract the tax benefits from damages would place an unfair burden on taxpayers generally. . . . Such a result leaves the government bearing the cost of defendants' fraud. A better result is to set damages equal to the [plaintiffs'] losses exclusive of tax benefit. The [plaintiffs] will not receive a double benefit from this measure of damages because under the tax benefit rule their prior tax benefits will be disallowed. . . .
>
> We are aware that in other circumstances tax consequences have been considered in determining damages. . . .

> In such cases where there is prospective calculation of damages for which no past tax benefits have been claimed, it is appropriate to calculate damages net of taxes. . . . [Such a] situation is clearly different from the present tax shelter situation in which the [plaintiffs] have received substantial benefits at government expense.

Burgess v. Premier Corp., 727 F.2d at 837-38. The Ninth Circuit goes on to consider the holding in *Austin I* and declines to follow it. *Id.* at 838. The Ninth Circuit concludes:

> While we agree that consideration of tax consequences is relevant for certain purposes, we decline to make the government the banker for fraudulent tax shelter activity. Judge Hardy's analysis in *Western Federal Corp. v. Davis*, 553 F. Supp. 818, 820 (D. Ariz. 1982) is correct in discerning that the economic benefit by way of tax deductions is illusory because amended returns will have to be filed under the tax benefit rule. Mertens *Law of Federal Income Tax*, §7.37.

Id.; accord, Western Fed. Corp. v. Erickson, 739 F.2d at 1444; *Johns Hopkins Univ. v. Hutton*, 297 F. Supp. at 1232 ("amounts to be applied to taxes were payments for that purpose, and are therefore not to be considered as either 'income' or 'consideration' "); *cf. Eisenberg v. Gagnon*, 766 F.2d 770, 782 (3d Cir. 1985).

The Second Circuit takes yet another approach. The Second Circuit states:

> To the extent that plaintiffs invested in a tax shelter, all benefits they received from their investment, including tax benefits, would have to be deducted in calculating the rescissionary damages, if any to which they would be entitled.

Salcer v. Envicon Equities Corp., 744 F.2d 935, 940-41 (2d Cir. 1984), *petition for cert. filed*, 53 U.S.L.W. 3688 (U.S. Mar. 13, 1985) (No. 84-1447); *accord, Freschi v. Grand Coal Venture*, 767 F.2d 1041, 1050-51 (2d Cir. 1985), *petition for cert. filed*, 54 U.S.L.W. 3154 (U.S. Sept. 6, 1985) (No. 85-377).[6] Although that part of the Second Circuit's decision is consistent with the Eighth Circuit's decision, *see Austin II* at 955, the Second Circuit goes on to deny a plaintiff recovery of the interest and penalties assessed against him and makes no allowance for the tax consequences of the recovery. *Freschi v. Grand Coal Venture*, 767 F.2d at 1050-51.

The Ninth Circuit refuses to permit tax consequences of an investment to increase or decrease damages available under section 10(b) and Rule 10b-5. The Second Circuit requires a reduction of damages based upon tax deductions taken prior to recovery, but it does not permit an increase of damages to compensate for taxes which are to be imposed on the recovery, and it awards no interest because interest would constitute "a windfall resulting from [the] opportunity to use money." *Freschi v. Grand Coal Venture*, 767 F.2d at 1051.[7] The Eighth Circuit requires a reduction for tax deductions prior to recovery and an addition for taxes to be imposed on the recovery itself and insists interest be added to (and subtracted from) the annual balances.

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[6] *Salcer v. Envicon Equities Corp.* and *Freschi v. Grand Coal Venture* are Rule 10b-5 cases based on rescissionary damage theories, not section 12(2) rescission cases.

[7] One commentator noted:

> If [income tax benefits have been obtained by the investor and if those benefits reduce rescission damages], the investor is in effect paying to the general partner or promoter the tax benefits which [the investor] obtained—thereby providing a windfall to the defendants . . . .

S. Banoff, *To What Extent Will Benefits from Tax Shelters be Permitted to Offset Rescission Damages*, 57 J. TAXATION 154, 157 (1982).

Thus, there is a conflict which runs three ways. It is up to this Court to resolve that conflict. Note, *Tax Shelter Schemes & Damages in the Eighth Circuit,* 18 CREIGHTON L. REV. 1307, 1328 (1985).

II.

THE EIGHTH CIRCUIT'S DECISION MISINTERPRETS THE APPLICABLE STATUTES.

In *Ernst & Ernst v. Hochfelder,* 425 U.S. at 197, this Court stated that "the starting point" for the interpretation of the federal securities laws "is the language [of the statute] itself." The Eighth Circuit disregards the clear language of section 12(2) and effectively rewrites the statute under the guise of interpreting it. The Eighth Circuit also misconstrues section 28(a) of the Securities Exchange Act of 1934 [hereinafter "section 28(a)"].

Absent a clearly expressed legislative intent to the contrary, the language of a statute must ordinarily be regarded as conclusive. *Consumer Prod. Safety Comm'n v. GTE Sylvania, Inc.,* 447 U.S. 102, 108 (1980). In construing a statute, the statute's meaning must be sought first from the language employed. If the language itself is plain, it is the duty of a court to enforce the statute as written. *United States v. Standard Brewery, Inc.,* 251 U.S. 210, 217 (1920). If the wording of a statute is plain, simple and straightforward, the words employed must be accorded their normal meaning. *Kananen v. Matthews,* 555 F.2d 667, 670 (8th Cir.), *cert. denied sub. nom. Kananen v. Califano,* 434 U.S. 939 (1977); *see also Helvering v. Hammel,* 311 U.S. 504, 510-11 (1941).

A.

The Eighth Circuit's Decision Distorts The Normal Meaning Of Section 12(2).

Section 12(2)'s language is straightforward. The statute allows a defrauded purchaser

> to recover the consideration paid for such security with interest thereon, less the amount of any security received thereon, upon tender of such security . . . .

The formula has three parts: (1) the consideration paid, (2) interest on the consideration and (3) income received.

The district court consistently attempted to be faithful to the canons of statutory construction. At the end of the first trial, the district court refused to reduce the recovery under section 12(2) on account of tax benefits. Appendix at F-7-10. After the Eighth Circuit directed that "tax benefits" be equated with "income," the district court on remand stated:

> [The defendants'] approach would be to subtract the tax benefits from consideration paid before adding on interest, a course that drastically reduces or completely obliterates each plaintiff's award. However, the clear language of [section] 12(2) presents the order in which to consider these items: "consideration paid . . . with interest thereon, less the amount of any income received . . . ." These words present an express directive to this court, and [the] defendant[s] cite no cases directly on point which hold to the contrary.

Appendix at C-7.

Although the Eighth Circuit acknowledges that "tax benefits received are [not] a form of income in a strict accounting sense," *Austin II* at 955, it nevertheless holds that

> section 12(2)'s language "income *received* thereon" may properly be construed as including tax benefits bargained for and received . . . .

Id. at 958 (emphasis in original).

The Eighth Circuit disregards the "normal meaning" of the word "income." "Income" means "gain derived from capital, from labor, or from both combined." *Eisner v. Macomber*, 252 U.S. 189, 207 (1920).[8] "Income" does not include every favorable economic consequence,[9] *see United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 855 (1975) ("payment of interest, with its consequent deductibility for tax purposes," does not constitiute income within context of federal securities laws), and "loss" does not include every unfavorable one. If "income" and "loss" were to be construed to do so, damage calculations (and tax returns) would be required to account for all unrecognized appreciation, depreciation, changes in market price and opportunity costs. *E.g., Wolf v. Banco Nacional de Mexico, S.A.*, 739 F.2d 1458 (9th Cir. 1984), *cert. denied*, 83 L.Ed.2d 778 (1985) (claim of damage based on change in value of Mexican peso in comparison to American dollar).

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[8]One commentator noted that "*Austin* is without precedent in classifying tax benefits received by the plaintiff as 'income' within the meaning of section 12(2)." Note, *Austin v. Loftsgaarden: Securities Fraud in Real Estate Limited Partnership Investments*, 16 CREIGHTON L. REV. 1140, 1151 (1982).

[9]Respondents themselves did not argue that tax benefits constituted income. *Austin II* at 958 ("Loftsgaarden argues that . . . tax benefits are a return of 'consideration paid' "). In addition, their expert witness testified that "tax benefits" were not "income."

The Eighth Circuit also disregards the normal meaning of another portion of section 12(2). The Eighth Circuit concedes that under section 12(2) a defrauded purchaser will only be entitled "to recover the amount paid for [the security] with interest, less the amount received with interest." *Austin II* at 959, *quoting Murphy v. Cady*, 30 F. Supp. 466, 470 (D. Me. 1939), *aff'd*, 113 F.2d 988 (1st Cir.), *cert. denied*, 311 U.S. 705 (1940). The sentence structure and rules of syntax require that the words "interest thereon" modify only "consideration paid" and mandate that interest be calculated only on the consideration. No reasonable construction permits calculating or deducting interest on the "income received." *See Johns Hopkins Univ. v. Hutton*, 297 F.Supp. at 1233. Nevertheless, the Eighth Circuit holds that

> [b]ecause plaintiffs were not deprived of the use of the entire amount of their investments over the ten year period, prejudgment interest is due only on the amount of money they were out-of-pocket at any given time.

Austin II at 959. That interpretation is contrary to the statute's plain meaning.

B.

The Eighth Circuit's Decision Misinterprets Section 28(a).

Section 28(a) provides:

> The rights and remedies provided by this chapter shall be in addition to any and all other rights and remedies that may exist at law or in equity; but no person permitted to maintain a suit for damages under the provisions of this chapter shall recover, through satisfaction of judgment in one or more actions, a total amount in

> excess of his actual damages on account of the act complained of . . . .

The Eighth Circuit concludes that "a plaintiff can recover no more than his 'net economic loss' " and holds that "net economic loss" is to be equated with "actual damages." *Austin II* at 954; *accord, Salcer v. Envicon Equities Corp.*, 744 F.2d at 940.

That interpretation begs the question of what is intended by the term "actual damages." The sentence structure suggests that Congress meant only to prevent duplicative recovery whenever a plaintiff asserted a state law claim as well as a federal securities law claim.

The first clause of section 28(a) demonstrates that federal remedies do not preempt state remedies. The phrase "actual damages," which is included in the following clause in section 28(a), is designed to prevent a plaintiff from recovering more than once if he pursues both federal and state causes of action.[10] *E.g., Osofsky v. Zipf,* 645 F.2d 107, 111 (2d Cir. 1981).

If this Court is not able to determine the intent from the language of the statute, it is entitled to consider "practical factors" and considerations of "policy" to explicate congressional intent in adopting section 28(a). *See Blue Chip Stamps v. Manor Drug Stores,* 421 U.S. 723, 749 (1975). All practical and policy considerations favor excluding tax benefits from a calculation of damages.

The Eighth Circuit's decision assumes that the tax benefits of investing in a limited partnership are attributable to

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[10]A strict construction of section 28(a), which refers only to "a suit for damages," may preclude any limitation on the equitable remedy of rescission. *See* Note, *Insiders Liability under Rule 10b-5 for the Purchase of Actively Traded Securities,* 78 YALE L. J. 864, 874 n.51 (1969).

the promoter and must be accounted for when damages are calculated. The assumption is false. Tax deductions are allowed by the government, not by the promoter; the benefit, if any, which results from the deductions is based upon the investor's tax situation; nothing is attributable to the promoter. *See Hayden v. McDonald*, 742 F.2d 423, 441-42 (8th Cir. 1984) (concurring opinion). By crediting a promoter who defrauded investors with tax benefits conferred by the government, the Eighth Circuit makes the "government . . . the banker for fraudulent tax shelter activity." *Burgess v. Premier Corp.*, 727 F.2d at 838.

Several harmful effects flow from the Eighth Circuit's decision. First, the Eighth Circuit's decision vitiates the "collateral source" rule. The rule is set forth in RESTATEMENT (SECOND) OF TORTS §920A(2) (1979):

> Payments made to or benefits conferred on [an] injured party from other sources are not credited against the tortfeasor's liability, although they cover all or a part of the harm for which the tortfeasor is liable.

The rule means that

> a benefit that is directed to the injured party should not be shifted so as to become a windfall for the tortfeasor. If the plaintiff was himself responsible for the benefit, as by maintaining his own insurance or by making advantageous employment arrangements, the law allows him to keep it for himself. If the benefit was a gift to the plaintiff from a third party or established for him by law, he should not be deprived of the advantage that it confers. *The law does not differentiate between the nature of the benefits, so long as they did not come from the defendant or a person acting for him.*

Id. comment b (emphasis added). The Eighth Circuit holds that

> the tax benefits of plaintiffs' investments are not a collateral source because "although paid by the government, [they] emanate directly from the tax shelters sought by the plaintiffs and provided by defendants, without which plaintiffs could not have realized any tax benefits. Benefits resulting directly from a transaction under attack must be credited toward the damage award."

Austin II at 956, *quoting Salcer v. Envicon Equities Corp.*, 744 F.2d at 941-42. That analysis misconstrues the nature of a "collateral source."

Every collateral source results directly from the tort or transaction at issue. Health and disability insurance are collateral sources even though they compensate an injured or disabled party for medical expenses and lost income resulting directly from the injury caused by the tortfeasor. *E.g., Dennison v. Head Constr. Co.*, 54 Md. App. 310, 319-22, 458 A.2d 868, 873-74 (1983); *Hueper v. Goodrich*, 314 N.W.2d 828, 830-31 (Minn. 1982). Such insurance is considered to come from a "collateral source" and does not reduce the damage for which the tortfeasor is liable. The rule applies even if the tortfeasor provides the benefits or contributes to a fund which does so. *E.g., Eichel v. New York Cent. R.R.*, 375 U.S. 253, 254-55 (1963); *NLRB v. Gullett Gin Co.*, 340 U.S. 361, 364 (1951); *Kauffman v. Sidereal Corp.*, 695 F.2d 343, 346-47 (9th Cir. 1983); *United States v. Gray*, 199 F.2d 239, 244 (10th Cir. 1952) (government's provision of veterans hospitalization benefits does not diminish portion of damage award against government which constituted cost of treatment).

The proper question is whether the benefit comes from Respondents. Petitioners' tax benefits come from a third party, *i.e.*, the government, and are established by law. R. Thompson, *The Measure of Recovery under Rule 10b-5*, 37 VAND. L. REV. 349, 390 (1984) ("plaintiff who receives

a tax benefit obtains his advantage from the government, not from the defendant"). The tax benefits do not come from Respondents. Any other interpretation would mean that tax benefits which emanate from sources collateral to the investment, *i.e.*, (1) tax incentives created by the government to encourage improvements to real estate and (2) an investor's other taxable earnings, would inure to a defrauder and not to the investor whom the incentives were intended to benefit and who had other earnings. *See Funston v. United States*, 513 F. Supp. 1000, 1010 (M.D. Pa. 1981) ("tax benefit conferred by [the state] is from a collateral source"); *Iowa-Des Moines Nat'l Bank v. Schwerman Trucking Co.*, 288 N.W.2d 198, 205 (Iowa 1980) ("tax saving [is to be] treated as a collateral source"); *Cereal Byproducts Co. v. Hull*, 16 Ill. App. 2d 79, 81, 147 N.E.2d 383, 384, *aff'd*, 15 Ill. 2d 313, 155 N.E.2d 14 (1958) (tax consequences of theft loss treated as being from collateral source); *Lumber Terminals, Inc. v. Nowakowski*, 36 Md. App. 82, 97, 373 A.2d 282, 291-92 (1977) ("[t]axes are strictly between plaintiff as taxpayer and the government as collector, and are of no legitimate concern of the defendants").

Second, the Eighth Circuit's decision does violence to the rule which prohibits fiduciaries from profiting from transactions with their beneficiaries. Here Loftsgaarden committed a massive fraud; yet the Eighth Circuit allows him to take an undisclosed profit, to profit further from the ability to use for twelve years the monies he obtained and to return only a fraction of the original profit.

Third, the Eighth Circuit's decision reduces government revenue. The decision limits the defrauder's liability for damages and thereby reduces the investor's recovery. Be-

cause the investor's recovery would have been taxable, the decision guarantees that the public purse is to be used to provide a profit to fraudulent promoters. *See Western Fed. Corp. v. Davis,* 553 F. Supp. at 821.

Fourth, the Eighth Circuit's analysis accounts for some, but not all, of the tax consequences of the transaction: the tax benefits that a plaintiff receives during the time prior to the limited partnership's insolvency, the taxes paid at the time of insolvency and the assumed taxes to be paid as a result of an award of "damages." The analysis does not take into account the need to amend earlier returns, *see, e.g., Western Fed. Corp. v. Davis,* 553 F. Supp. at 820; *Rhode v. Hershberger Explorations, Inc.,* 349 F. Supp. 993, 994 (D. Minn. 1972), or the government's ability to correct an error made in a prior tax year and to obtain an adjustment of tax liability despite the running of the ordinary period of limitations. *See* 26 U.S.C. §§1311-1314; *but see Austin II* at 956; *Salcer v. Envicon Equities Corp.* 744 F.2d at 942-43.

Finally, the Eighth Circuit's rule creates anomalous damage awards. Investors in different tax brackets, but identically situated in every other way, are to receive damages in differing amounts. Damage awards will vary widely based upon factors which have nothing to do with the investments or with the frauds which occasion the awards if tax consequences must be considered. Even though Randall, Austin and Anderson each invested $35,000.00 and even though none received any cash or cash equivalent as a return on his investment in Alotel Associates, each is to recover a different amount: Randall ($506), Austin ($7,666) and Anderson ($18,790). *Id.* at 961; *compare Hayden v. McDonald,* 742 F.2d at 425 & 439 (56 plaintiffs and presumably 56 different results). Disparate treatment of investors based

upon differences in their taxable income undermines the purposes of the federal securities laws. *See Herman & MacLean v. Huddleston*, 459 U.S. at 390 (defrauded investors are persons whom securities laws seek to protect).

The rule also enables plaintiffs and defendants to increase the amount of damages. Because tax benefits depend upon an investor's "ordinary income" and marginal tax bracket, a plaintiff may manipulate the timing of his receipt of such "ordinary income" and thereby increase his damages. A defendant may also manipulate the amount of tax benefits (and of damages) by his own ability to make elections. S. Banoff, *To What Extent Will Benefits from Tax Shelters be Permitted to Offset Rescission Damages*, 57 J. TAXATION 154, 155-56 (1982).

III.

THE EIGHTH CIRCUIT'S DECISION IS CONTRARY TO PRECEDENT.

A.

The Eighth Circuit's Decision Fails To Defer To This Court's Precedent.

The impact of income taxes on damages available is a recurring subject for this Court's consideration. The applicable principles are the subject of no less than three separate, significant opinions.

In *Hanover Shoe, Inc. v. United Shoe Mach. Corp.*, 392 U.S. 481 (1968), this Court first addressed a party's argument that an adversary's damages must be reduced to the "after-tax profits that [the adversary] failed to receive." *Id.* at 503. This Court held that

> to diminish the actual damages by the amount of taxes that [a plaintiff] would hav paid had it received greater

> profits in the years it was damaged would be to apply a double deduction for taxation, leaving [the plaintiff] with less income than it would have had if [the defendant] had not injured it.

Id. This Court recognized that changing rates of taxation, expired statutes of limitation and difficulties in recomputing taxes which would have accrued over a period of years, stated that

> the rough result of not taking account of taxes for the year of injury but then taxing recovery when received seems the most satisfactory outcome,

id., and held that damages should equal pre-tax profits and that the IRS should be permitted to tax the recovery. *Id.*

In *Norfolk & W. Ry. v. Liepelt,* 444 U.S. 490 (1980), this Court considered the question of whether a refusal of an instruction that any award of damages would not be subject to income taxation was error. *Id.* at 491. This Court recognized an injured individual's after-tax income, not his gross income before taxes, was the relevant factor in calculating the damages sustained by his dependents when he died. *Id.* at 493-94. This Court again recognized the complexities in predicting the many variables; nevertheless, it held that the danger of overcompensation based on an erroneous assumption concerning taxability required the admission of expert testimony concerning income tax liability for future wages and the giving of an instruction that a judgment would not be taxable. *Id.* at 497-98.

In *Jones & Laughlin Steel Corp. v. Pfeifer,* 462 U.S. 523 (1983), this Court offered guidance to those seeking to reconcile its pronouncements in *Hanover Shoe* with those in *Liepelt*. This Court stated that, when the damage award

itself is to be tax-free, the evidence to be considered is that concerning *after-tax* amounts. This Court implied that, when the damage award itself is taxable, evidence of taxes paid or to be paid should be excluded. *Id.* at 547-51.

The Eighth Circuit interprets *Liepelt* to apply to Petitioner's claims for damages and for rescission even though the Eighth Circuit recognized that each would "have to pay taxes on his award." The Eighth Circuit fails to consider *Hanover Shoe* or *Pfeifer*. In doing so, the Eighth Circuit glosses over *Liepelt's* predicate that its holding applies only when an award of damages is not taxable.

B.

The Eighth Circuit's Decision Fails To Defer To Other Courts' Precedent.

Courts had been interpreting the federal securities laws and had been providing remedies for over thirty years before the deductibility of tax benefits surfaced as an issue. *See Cooper v. Hallgarten & Co.*, 34 F.R.D. 482 (S.D.N.Y. 1964). When defendants began to argue that they should be able to reduce a plaintiff's recovery by an amount equal to the tax benefits flowing from an investment, courts uniformly rejected those arguments. *See, e.g., Rhode v. Hershberger Explorations, Inc.*, 349 F. Supp. at 944; *Johns Hopkins Univ. v. Hutton*, 297 F. Supp. at 1232; *Wiesenberger v. W. E. Hutton & Co.*, 35 F.R.D. 556, 557 (S.D.N.Y. 1964); *Cooper v. Hallgarten & Co.*, 34 F.R.D. at 484.

Courts eventually allowed discovery of information concerning tax benefits because of the information's relevance to issues other than damages. *See Smith v. Bader*, 83 F.R.D. 437, 438-39 (S.D.N.Y. 1979); *Sharp v. Coopers & Lybrand*, 83 F.R.D. 343, 352 (E.D. Pa. 1979), *rev'd on other*

grounds, 649 F.2d 175 (3d Cir. 1981), *cert. denied*, 455 U.S. 938 (1982); *Houlihan v. Anderson-Stokes, Inc.*, 78 F.R.D. 232, 233-34 (D.D.C. 1978). Courts which permitted such discovery considered the tax benefits relevant to the issue of valuation of the investment, *see Dupuy v. Dupuy*, 551 F.2d 1005, 1025 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977); *Smith v. Bader*, 83 F.R.D. at 439; *accord*, *Berg v. Xerxes-Southdale Office Bldg. Co.*, 290 N.W.2d 612, 615 (Minn. 1980), to the issue of misrepresentation of tax benefits, *Bridgen v. Scott*, 456 F. Supp. 1048, 1062 (S.D. Tex. 1978); *Bayoud v. Ballard*, 404 F. Supp. 417, 426 (N.D. Tex. 1975), to the issue of causation, *see Houlihan v. Anderson-Stokes, Inc.*, 78 F.R.D. at 234, to the issue of reliance, *see Smith v. Bader*, 83 F.R.D. at 439; *Sharp v. Coopers & Lybrand*, 83 F.R.D. at 352, and to the issue of laches. *See Hickman v. Groesbeck*, 389 F. Supp. 769, 780 (D. Utah 1974).

The Eighth Circuit was the first to totally reject existing precedent and to permit defendants to introduce evidence of tax benefits and to require that those benefits offset damages. *Austin I* at 183; Note, *Austin v. Loftsgaarden: Securities Fraud in Real Estate Limited Partnership Investments*, 18 CREIGHTON L. REV. 1140, 1151 (1982) ["*Austin* is without precedent in classifying tax benefits as income within the meaning of section 12(2)"]. Other courts continued to reject the Eighth Circuit's aproach. *E.g.*, *Eisenberg v. Gagnon*, 766 F.2d at 782 (deductability of losses not to be considered in assessing damages); *Western Fed. Corp. v. Erickson*, 739 F.2d at 1444; *Burgess v. Premier Corp.*, 727 F.2d at 837-38; *G & R Corp. v. American Sec. & Trust Co.*, 523 F.2d 1164, 1176 (D.C. Cir. 1975); *Spatz v. Borenstein*, 513 F. Supp. 571, 577-86 (N.D. Ill. 1981);

see also Danzig v. Jack Grynberg & Assoc., 161 Cal. App. 3d 1128, 1139-40, 208 Cal. Rptr. 336, 343-44 (1984), *petition for cert. filed*, 53 U.S.L.W. 3826 (U.S. May 14, 1985) (No. 84-1784) (limited partners' tax consequences irrelevant to their rescissionary recovery based upon misrepresentation); *Harris v. Metropolitan Mall*, 112 Wis. 2d 487, 501-02, 334 N.W.2d 519, 526 & n.21 (1983); *Iowa-Des Moines Nat'l Bank v. Schwerman Trucking Co.*, 288 N.W. 2d at 205; *Borovoy v. Bursar Realty Corp.*, 86 Mich. App. 732, 738, 273 N.W.2d 545, 548 (1979) (tax consequences "do not enter into the computation of damages" under state securities laws); *Cereal Byproducts Co. v. Hall*, 16 Ill. App. 2d at 81, 147 N.E.2d at 384; *cf. Hokama v. E.F. Hutton & Co.*, 566 F. Supp. 836, 847-48 (C.D. Cal. 1983). The Second Circuit, however, adopted the Eighth Circuit's approach. *See Freschi v. Grand Coal Venture*, 767 F.2d at 1050-51; *Salcer v. Envicon Equities Corp.*, 744 F.2d at 940-44.

There was no reason to reject precedent. The Second and Eighth Circuits should have deferred[11] to the rationale and holdings of the earlier cases.

IV.

THE EIGHTH CIRCUIT'S DECISION UNDERCUTS THE DISCLOSURE REQUIREMENTS OF THE FEDERAL SECURITIES LAW.

The Securities Act of 1933 is "a system of full disclosure." T. Hazen, THE LAW OF SECURITIES REGULATION §1.2 at 7 (1985); *see also* 1 L. Loss, SECURITIES

[11]Neither the Second Circuit nor the Eighth Circuit deferred to the expertise of the SEC with respect to the interpretation of the federal securities laws or the expertise of the Tax Division with respect to the interpretation of the internal revenue laws.

REGULATION 184 (2d ed. 1961). The Securities Exchange Act of 1934 is intended to regulate all aspects of the public trading of securities, bars material misstatements and omissions and requires full disclosure. *Id.*

The necessity of full disclosure is implemented by the SEC's examination of registration documents to determine compliance with the securities laws' disclosure requirements, by the SEC's initiation of injunction proceedings, by the SEC's administrative hearing and sanction procedures, by criminal prosecutions and by private litigants' suits for restitution and damages. T. Hazen, THE LAW OF SECURITIES REGULATION §1.3 at 10-11 (1985); 1 L. Loss, SECURITIES REGULATION 302-03 (2d ed. 1961); 2 L. Loss, SECURITIES REGULATION 845-57 (2d ed. 1961); T. Hazen, *Administrative Enforcement: An Evaluation of the SEC's Use of Injunctions & Other Enforcement Methods,* 31 HASTINGS L. J. 427 (1979); *see also United States v. Naftalin,* 441 U.S. 768 (1979); *Red Bank Oil Co.,* 20 S.E.C. 863, 866 (1945).

The Securities Act of 1933 exempts certain securities from its registration requirements because of the "small amount involved"[12] or because of the limited character of the public offering, 15 U.S.C. §77c, and exempts certain transactions because of the nature of the transactions or the participants. 15 U.S.C. §77d. Most limited partnership offerings[13] fall within one or more exemptions.[14] Therefore,

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[12]The total amount invested in limited partnerships in 1983 was estimated to be $8.4 billion. TIME, Nov. 26, 1984, at 26.

[13]In 1980 there were approximately 211,000 real estate limited partnerships in existence. Bureau of Nat'l Affairs, Inc., *Daily Report for Executives* (Feb. 21, 1984).

[14]In a 12 month period during 1975-1976 only 10 limited partnerships were registered with the S.E.C. [1976] 5 FED. SEC. L. REP. (CCH) at 64,214. In a similar period during 1984-1985 less than 60 real estate limited partnerships registered. [1985] 6 FED. SEC. L. REP. (CCH) Br. 5 & 6 at 64,264-77.

the SEC has no opportunity to examine documents prior to sale. Because neither SEC nor the Department of Justice has the resources to police all of the fraudulent activity by organizers of limited partnerships,[15] the primary tool in enforcing the disclosure requirements is the private civil action. Note, *Real Estate Limited Partnerships & Allocational Efficiency: The Incentive to Sue for Securities Fraud,* 63 VA. L. REV. 669, 670-71 (1977).

The incentive to make full disclosure is in direct relation to the likelihood and risk of a successful suit. *Id.* at 671. The Eighth Circuit's decision makes it unlikely that defrauded investors will sue and minimizes the risk to the fraudulent promoter in the unlikely event that they do sue. *Id.* at 671-72. One commentator described the Eighth Circuit's message to potential promoters:

> Relax. Should a violation of the securities law occur, promoters in the Eighth Circuit apparently need only assure themselves that the investors get a large enough tax deduction.

Note, *Austin v. Loftsgaarden: Securities Fraud in Real Estate Limited Partnership Investments,* 16 CREIGHTON L. REV. 1140, 1152 (1983).

Allowing the Eighth Circuit's decision to stand encourages thousands of promoters to omit or to misrepresent information material to potential investors. Like Loftsgaarden, those promoters will hope to pocket in excess of $100,000, to keep all of the money for twelve years and then to return less than $30,000. The decision will discourage the tens of thousands of investors who look at Randall and see only a man who invested $42,500 as a result of a fraud, who spent thousands of dollars trying to salvage his investment and

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[15]Fraud continues to grow despite the efforts of federal and state enforcement agencies. *Washington Post,* Jun. 4, 1984, at A-11.

who was left with nothing but an expenditure of almost ten years and additional thousands of dollars in attorney's fees in pursuit of his recovery of $506.

This Court must insist on the disclosure required by statute. To do so, it must insure the continued viability of the express and implied remedies for violations of the securities laws' disclosure requirements. To do otherwise is to undercut the protective purpose of the securities laws. *See* R. Thompson, *The Measure of Recovery under Rule 10b-5*, 37 VAND. L. REV. 349, 390 (1984) ("[f]ocusing on the defendant and resolving doubts against the party committing the fraud is consistent . . . with the dual deterrent/compensatory purposes of the federal securities laws" and requires that there be no deduction for tax benefits); *United States v. Naftalin*, 441 U.S. at 774-77.

CONCLUSION

For the foregoing reasons, a writ of certiorari should issue to review the judgment and opinion of the Eighth Circuit.

Respectfully submitted,

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